



15 December 2014

Ms. Annie Choi
Commissioner of Insurance
Office of the Commissioner of Insurance
21/F, Queensway Government Offices
66 Queensway
Hong Kong

RE: ASHK Comments on the Consultation Paper on a Risk-based Capital Framework for the Insurance Industry of Hong Kong

Dear Ms. Choi,

The Actuarial Society of Hong Kong ("ASHK") appreciates the opportunity to offer comments on the Consultation Paper on a Risk-based Capital Framework for the Insurance Industry of Hong Kong dated 15 September 2014 issued by the Insurance Authority.

The proposed revised RBC Framework will fundamentally change the solvency supervision of insurers in Hong Kong for decades to come. Moreover, many of the proposed changes are of an actuarial nature. We believe therefore that it is central to our mission that we provide input from a professional actuarial point of view.

These comments were developed by the ASHK's RBC Task Force and approved by the ASHK Council. The views expressed herein are those of the ASHK and are not necessarily those of any employer of ASHK members.

ASHK would particularly like to have the opportunity to engage directly with the IA as you further develop your thinking about the direction for the new framework and we would like to understand more clearly how ASHK can be involved on an ongoing basis. Many of our members have significant expertise in this area and we would like to offer our assistance. In this regard we note the recommendation in the IMF's "Detailed Assessment of Observance - Insurance Core Principles" dated June 2014 that "the IA might consider closer collaboration with the ASHK to better support the local insurance industry".

We are ready to discuss our views in person with you and to answer any questions or respond to any comments that you may have.

Yours faithfully,

Billy Wong
President
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Contents

1. Introduction	1
1.1. Background	1
1.2. Need for change	1
1.3. Guiding Principles	2
1.4. Organization of this comment letter	3
2. Role of the Actuary and the ASHK	4
2.1. Role of the Appointed / Certifying Actuary	4
2.2. Role of Actuaries Generally	4
2.3. Role of the ASHK	5
3. Answers to Questions Posed in the Consultation Paper	7
Question 1	7
Question 2	7
Question 3	7
Question 4	9
Question 5	9
Question 6	9
Question 7	10
Question 8	10
Question 9	11
Question 10	11
Question 11	12
Question 12	12
Question 13	13
Question 14	13
Question 15	14
Question 16	14
Question 17	15
Question 18	16
Question 19	17
Question 20	17
Question 21	17
Question 22	18
Question 23	18
Question 24	18
Question 25	18
Question 26	19
Question 27	19
Question 28	19
Question 29	19
Question 30	20
Question 31	20
Question 32	20
Question 33	20
Question 34	21
Question 35	21
Question 36	22
Question 37	22
Contract Boundaries	22
Diversification	23
ERM Generally	23
Treatment of Reinsurers, Requirements for Offshore Reinsurance Funds and Captives	23

1. Introduction

1.1. Background

The Actuarial Society of Hong Kong ("ASHK") appreciates the opportunity to offer comments on the Consultation Paper on a Risk-based Capital Framework for the Insurance Industry of Hong Kong ("CP") dated 15 September 2015 issued by the Insurance Authority ("IA"). The ASHK is a professional membership organization for actuaries in the industries of insurance, consultancy, finance, educational institutions and government. The ASHK has been a full member of the International Actuarial Association since 1999. The ASHK is governed by an elected Council with a President, an Immediate Past President, a Vice President and ten Council Members. Currently the ASHK has over 900 members.

Among the objectives of the ASHK are the following:

- To discuss and comment on the actuarial aspects of public, social and economic and financial questions which from time to time may be the subject of public interest;
- To consider the actuarial aspects of legislation existing and proposed and to take such action as is considered desirable.

The proposed revised RBC Framework ("Framework") will fundamentally change the solvency supervision of insurers in Hong Kong for decades to come. Moreover, many of the proposed changes are of an actuarial nature. We believe therefore that it is central to our mission that we provide input from a professional actuarial point of view. The views expressed herein are those of the ASHK and are not necessarily those of any employer of ASHK members.

The ASHK believes that the existing solvency supervision framework has served Hong Kong reasonably well historically. It provides a substantial level of assurance that policyholder obligations will be met, even in times of crisis. However, the ASHK also believes that the existing framework can benefit from modernization. We are keen to support the IA's initiative in this regard and we welcome the prospect of a new, well-designed and well-considered risk-oriented framework.

We believe that the Appointed Actuary and the ASHK both have important roles to play in the revised Framework and we look forward to a productive dialogue with the IA in this regard. The Appointed Actuary system has served Hong Kong well since its introduction and we believe it has an important place in the revised Framework. Similarly, the ASHK has supported the IA in developing Actuarial Guidance Notes ("AGNs") to assist Appointed Actuaries in the interpretation of the current regulations. We believe the ASHK or its successor can and should continue to play this role under the revised framework. These points are elaborated further in our report.

The ASHK agrees with the IA's objective to better protect policyholders and conform to international standards, in particular to the Insurance Core Principles ("ICPs") as promulgated by the International Association of Insurance Supervisors ("IAIS"). We believe this process requires that the full range of potential impacts of proposed changes to the regime be carefully considered in order to avoid unintended and adverse consequences, and to ensure future stability. In this regard we note the IA's intent to conduct a Quantitative Impact Study ("QIS") after the Framework has been agreed and further note that experience in other jurisdictions has shown that two or more QIS's are likely to be necessary before the details of the new regime can be finalized.

1.2. Need for change

Although the existing system has served Hong Kong relatively well historically, it has a number of major disadvantages. Among the major shortcomings of the current regime are the following:

- The current framework does not adopt a total balance sheet approach. For example, asset risks and risks related to asset / liability mismatch are not catered for.

- Policy liabilities are based on a net premium approach with a rule-based approach to setting valuation interest rates. The result is that the policy liabilities are not a realistic representation of the insurer's obligations under the contracts. Rather the policy liabilities are conservative. The amount of conservatism varies from company to company and within a given company from product group to product group by an unknown amount.
- A number of more recent products, such as variable annuities with minimum guarantees and universal life products with secondary guarantees are not well catered for. A high degree of interpretation is required to value such contracts.
- Capital requirements are not risk-sensitive. In general market risks (interest rate risk, credit risk, etc.) are ignored, while liability risks are measured based on formulae that are unrelated to the actual risks in the products
- There are very few requirements around enterprise risk management, including asset / liability management.

Given the above and considering as well developments in solvency regulation globally, the ASHK is supportive of modernizing the Hong Kong solvency supervision framework. We see many potential benefits to such modernization, including:

- Improved policyholder protection cost effectively
- More transparency around the actual risk profiles of insurers
- Creation of incentives for companies to better understand their actual risk profiles and to manage their risks
- A greater ability for the IA to distinguish well capitalized from poorly capitalised companies
- A more refined approach to solvency supervision
- An approach that caters for a wider variety of product types than is the case under the existing framework
- Levelling the playing fields making Hong Kong an attractive, competitive and respectable domicile for insurance groups

1.3. Guiding Principles

The ASHK believes that the new Framework should adhere to the following overriding principles:

- Be compatible with the social purposes of insurance, including fostering long term savings and providing protection against the risks of death and serious illness. To that end, by way of example, any new framework should avoid penalizing products with long term guarantees that are prudently underwritten;
- Allow the regulator to distinguish poorly capitalized companies from well capitalized companies;
- Incorporate the views of the community of international supervisors as embodied in the Insurance Core Principles ("ICPs") published by the International Association of Insurance Supervisors. ICP-compliance is a necessary characteristic of the Framework;
- Encourage responsible risk-taking behaviours and recognize risk mitigation techniques, such as hedging, reinsurance, loss absorbing capacity of participating business, etc.;
- Required regulatory capital should be based on a realistic and prudent assessment of the financial risks but should not result in companies being forced to hold capital materially in excess of that required to cover these risks, since otherwise the cost of insurance to consumers is increased

unjustifiably and the writing of certain types of insurance that would be desirable for consumers is discouraged;

- The new Framework should be as practical and simple as possible while still meeting the above objectives. Theoretical approaches that are difficult to implement practically and reduce transparency should be avoided if simpler solutions can serve the purpose equally well;
- Ensure a healthy, growing insurance sector that will support the development of Hong Kong's economy and capital markets;
- Seek to create a level playing field among all insurers operating in Hong Kong;
- Avoid placing Hong Kong headquartered international insurers at a competitive disadvantage in other jurisdictions by placing requirements on them that are more onerous than those applied to insurers based in the other markets with sound, ICP-compliant, solvency supervision frameworks in which they operate;
- Assets and liabilities should be measured consistently; however both should be measured in such a way that the underlying solvency position is not distorted by short term market movements that are not reflective of long term economic trends;
- Because it should be principle-based, the new Framework should cater for a wider collection of product types than the current regime;
- Ensure that no unintended consequences are created, for example requirements to hold excessive capital may impact policyholders and the attractiveness of insurance products to customers through:
 - Higher product prices as a result of needing to attract and therefore pay a return on any additional capital required to be held;
 - Reduced policyholder benefits due to conservative capital requirements based on short term volatility driving investment into a greater proportion of low risk/low return assets;
 - Impaired ability of insurance companies to provide long term guarantees that other financial institutions are unable to provide and which otherwise are not available in the market
 - More limited policyholder choice, for example a reduction in guaranteed savings type products caused by the imposition of a cash value floor. Because a cash value floor could create technical insolvency in times of stress, companies will be incentivized to withdraw products with significant savings components.

1.4. Organization of this comment letter

In section 2 we express our views on what we believe should be the role of the actuary under the new Framework as well as the role of the ASHK. In section 3 we provide answers to each of the questions posed in the CP as well as comments on several matters that were not the subject of specific questions in the CP.

2. Role of the Actuary and the ASHK

2.1. Role of the Appointed / Certifying Actuary

Under the current framework, actuaries have a number of statutorily defined roles, including:

- The Appointed Actuary ("AA") of a long term insurer has the statutory obligation under Chapter 41 of the Insurance Ordinance to:
 - Conduct, at least annually, an investigation of the financial condition of the insurer, including valuation of liabilities (s. 18); and
 - Certify the profit and loss statement submitted by the directors (Sch. 3, Part 1, #5).
- Guidance Note 7 ("GN7") issued by the IA requires an insurer authorized to carry on Class G business to submit annually a report certified by its Appointed Actuary demonstrating that the guidance in GN7 has been followed.
- Guidance Note 9 ("GN9") issued by the IA requires a Certificate of Actuarial Opinion on Insurance Liabilities of Employee' Compensation and Motor Insurance Business certifying the adequacy of such reserves.
- Guidance Note 13 ("GN13") issued by the IA requires a long term insurer to take into account relevant input on asset / liability management from its Appointed Actuary.

The ASHK believes that the Appointed Actuary system has served Hong Kong well over the years. We believe the role of the Appointed Actuary should continue under the new framework and be extended to cover both general insurance as well as long term insurance. Specifically, the current requirement for sign-off on reserves should continue for long term business and in fact be extended to general insurance business as well. A sign-off by a qualified, professional actuary will give management, policyholders and regulators assurance that technical provisions and required capital are adequate and follow the requirements of the Framework.

The AA must be properly qualified to perform his or her responsibilities. Currently Appointed Actuaries are required to be approved by the IA and to be fellows of either the Institute and Faculty of Actuaries (UK), the Australian Institute of Actuaries (now the Actuaries Institute), the Society of Actuaries (US) or the Casualty Actuarial Society (US). The ASHK believes that under the new framework these membership requirements should be replaced by a single requirement for fellow membership in the ASHK. Currently admission to fellow membership requires (i) fellowship in one of the four actuarial societies mentioned above, or demonstration of equivalent knowledge as determined by the ASHK Council, and (ii) the recommendation by two existing fellow members. The ASHK is currently in the initial stages of developing an examination to test knowledge of local valuation and taxation regulations. Passing this examination could be a further requirement for a person to be named an Appointed Actuary in Hong Kong.

The ASHK has now reached a stage of maturity where fellow membership in the ASHK rather than foreign actuarial societies should be among the qualifications required of an Appointed Actuary. Fellowship in the ASHK will ensure that Appointed Actuaries possess the requisite local knowledge and experience as well as the general broad-based actuarial knowledge conferred by fellowship in the other bodies. The ASHK is *the body* that represents the Hong Kong actuarial profession. This cannot be said of any of the other bodies.

Our recommendations in regard to the role of the Appointed Actuary are fully consistent with the recommendations of the IMF in its most recent assessment of Hong Kong's compliance with the Insurance Core Principles dated June 2014 (p105):

"The framework within which the appointed actuaries system operate should be strengthened; IA should enhance its requirements on appointed actuaries; eventually all actuaries should be required to be members in good standing of the ASHK."

2.2. Role of Actuaries Generally

It is clear that actuaries generally – those who support the Appointed Actuary, those in the ERM function, those with roles in the investment area – will be essential to a successful implementation of the new

Framework. As such, we believe it is important that the actuarial function be specifically recognized as required under the new Framework. This is consistent with ICP 8, *Risk Management and Internal Controls*. ICP 8.5 requires that “there is an effective actuarial function capable of evaluating and providing advice to the insurer regarding, at a minimum, technical provisions, premium and pricing activities, and compliance with related statutory and regulatory requirements. The actuarial function evaluates and provides advice on matters such as:

- the insurer’s actuarial and financial risks;
- the insurer’s investment policies and the valuation of assets;
- an insurer’s solvency position, including a calculation of minimum capital required for regulatory purposes and liability and loss provisions;
- an insurer’s prospective solvency position;
- risk assessment and management policies and controls relevant to actuarial matters or the financial condition of the insurer;
- distribution of policy dividends or other benefits;
- underwriting policies;
- reinsurance arrangements;
- product development and design, including the terms and conditions of insurance contracts;
- the sufficiency and quality of data used in technical provisions; and
- risk modelling in the ORSA and use of internal models.

ICP 8.5 further requires that the actuarial function should have access to and periodically report to the Board on matters such as:

- any circumstance that may have a material effect on the insurer from an actuarial perspective;
- the adequacy of the technical provisions and other liabilities;
- the prospective solvency position of the insurer; and
- any other matters as determined by the Board. is reproduced in the Appendix to this comment letter.

ICP 8.5 is reproduced in its entirety in the Appendix to this comment letter. Clearly, the intent of ICP 8.5 is that the actuarial function play an important role within Pillar 2 as well as Pillar 1. We wholeheartedly agree with this approach. We recommend IA to consider this carefully and include formal requirements for the actuarial function in the Capital Framework.

2.3. Role of the ASHK

The ASHK has played a significant role under the current solvency framework. In particular, we have developed a number of professional standards and guidance notes for actuaries in Hong Kong. The IA has endorsed these guidance notes and standards and has made it clear that it expects actuaries to comply with them. They include:

- Professional Standard 1, which set out standards of conduct for Appointed Actuaries, actuaries serving as directors, and actuaries serving as external advisors;
- AGN3, *Additional Guidance for Appointed Actuaries*, and its two Supplements which provide guidance on the valuation of policy liabilities under Section 8 of Chapter 41E of the Insurance Companies’ Ordinance
- AGN4, *Outstanding Claims in General Insurance*, which provides guidance to actuaries in determining estimates of the liabilities for outstanding claims of a general insurer or reinsurer in Hong Kong;
- AGN7, *Dynamic Solvency Testing*, which requires that the Appointed Actuary of a long term insurer prepares at least annually a Dynamic Solvency Testing (“DST”) Report on the insurer’s financial condition for the Board of Directors and sets out requirements on how the report is to be prepared.

We believe that the need for actuarial standards and guidance notes will continue under the new Framework. Indeed, because the new Framework is likely to be principle-based, the need for guidance may well increase. Depending on the final regulations, areas where guidance might be required include, for example,

- methodologies for determining the MOCE;
- methodologies for reflecting the costs of options and guarantees;
- guidance on setting discount rates;
- criteria for taking account of management actions in performing stress calculations
- a number of areas in the Pillar 2 space, including the ORSA, which is more robust than, and we expect would subsume the current DST.

At this point the outline of the new Framework is very high level. When more specifics are defined the ASHK will be in a better position to identify areas where technical clarifications might be useful. Also, we will be available to assist the IA as requested in reviewing draft regulations for technical clarity, ease of implementation, etc. We sincerely hope to be useful in contributing to this important initiative.

3. Answers to Questions Posed in the Consultation Paper

Question 1

Do you agree that a total balance sheet approach should be adopted in the assessment of solvency, valuation of assets and liabilities and determination of capital resources? If not, why?

ASHK Response

Yes, the ASHK agrees strongly. We feel that this principle is essential to the new RBC Framework.

Question 2

Do you agree that we should impose two different solvency control levels (PCR and MCR) explicitly? If not, why?

ASHK Response

Yes, the ASHK agrees. We note that ICP 17.4 explicitly requires that the supervisor establish two solvency control levels, namely a PCR above which the supervisor would not intervene on capital adequacy grounds and an MCR, which if breached, would trigger the strongest actions in the absence by the insurer of appropriate corrective action.

Question 3

Do you agree that the PCR should be determined on a going-concern basis and allow for one year's forecast new business? Do you agree with aligning PCR with a minimum investment grade based on VAR calculated at a 99.5% confidence level over a one-year time horizon? Do you agree that the same target criteria should be applied to all classes of business? If you disagree, what alternatives would you suggest? Why?

ASHK Response

Going Concern

The ASHK agrees that the overall capital requirement should be determined on a going-concern basis. This is consistent with regulatory capital being designed to support ongoing operations rather than focusing on policyholder security in the event of wind-up or closure to new business. For the sake of completeness, ASHK recommends strongly that the IA provides clear rationale within its final guidance on why a going-concern basis has been selected.

New Business

The ASHK agrees in principle that one year's forecast new business should be factored into the overall capital consideration as this is aligned with the use of a going-concern basis.

For short term business – i.e. non-life as well as short term life and health insurance – the ASHK agrees that it is imperative that new business should be included within the Pillar 1 calculations, including in any standard calculations proposed by the IA. This is because the duration of these types of liabilities is short (typically less than 5-years) and thus new policies account for a sizeable portion of the risk profile. We also observe that premium-based metrics have been consistently incorporated within the standardized solutions being developed in other geographies – e.g. RBC2 in Singapore, C-ROSS in China and Solvency II in Europe – and such an approach would ensure international consistency.

For long term life and health insurance business, the ASHK has some concerns over whether the industry as a whole has achieved the level of maturity required to include new business projections in the capital calculations initially. We therefore suggest that a practical approach is taken to the inclusion of new business in any standard Pillar 1 calculations proposed by the IA. For example, we note that the Solvency II standard formula applies instantaneous stresses to the balance sheet at the valuation date, and therefore does not take the changes in assets and liabilities in the 12 months following the valuation into

account. We understand that this has been done under the assumption that long term business and the risk profile underlying it will remain relatively stable over the one year valuation time horizon.

The ASHK also has some concerns as to whether new business could potentially be used as a means of reducing capital requirements through a positive value of new business despite the stressed environment. We therefore propose that where new business is included in the Pillar 1 calculations, a test be conducted to ensure that this does not happen.

A further issue that arises with the inclusion of new business is that it introduces another level of subjectivity into the capital calculation. We therefore consider that where new business is included in any standard Pillar 1 calculations, guidance will be required as to the volumes and mix of business to be assumed. This guidance should also be applicable for internal model style calculations.

In addition to the above, we note that new business, including the risks arising from higher or lower than expected volumes of new business, should be considered in a company's ORSA.

Confidence Level

The CP is clear in linking the selected 99.5% percentile or 1-in-200 year return period as being commensurate with the likelihood of default for a BBB rated corporate entity. Some additional evidence supporting this comparison should be cited to make the guidance more complete. ASHK appreciates that a key basis for the proposed confidence interval is that it is consistent with the metric emerging in a number of other regimes' solvency framework updates. This is welcome.

Set against this, the ability to demonstrably calibrate to a measure so extreme is hard to justify in practice. In the professional judgment of the ASHK members, we would suggest that few key insurance professionals – e.g. Chief Executive Officers, Chief Underwriting Officers, etc. – are likely to feel confident in expressing an opinion on the likely quantum associated with such an extreme result. In contrast, the same individuals would probably make a more confident assessment on the quantum of a 1-in-20 year loss.

The selection of an extreme percentile presumably reflects a desire to provide a high level of security to policyholders. However, given the general difficulty associated with estimating extreme outcomes both in terms of the expert judgment of key professionals (discussed above) and even established risk experts (e.g. inaccuracy in firms' catastrophe modelling when conducting post loss events), the ASHK suggests that specification of alternative confidence intervals be examined during the Quantitative Impact Study phase(s). Ultimately the framework needs to take into account the market landscape and special needs of the Hong Kong insurance industry.

A possible alternative approach to the suggested methodology is to calibrate the MCR capital charge to a lower return period loss, e.g. a 95th percentile or a 1-in-20 year result, but stress this figure using a flat multiplier (say four times greater) when setting PCR. This approach has the benefit of being more tangible and should increase the willingness of decision-makers to challenge and own the estimates rather than viewing them as abstract conceptual metrics.

Time Horizon

The ASHK is broadly comfortable with the one-year time horizon proposal on the calibration of stresses and risk factors in alignment with regulatory developments in other regimes. However, for long term business, especially, we note that there are issues around implementation and subjectivity. For long term business a projection will involve substantial additional calculations beyond what is necessary if the calculation were to be done as of the balance sheet date. Also, if new business is projected based on business plans, comparability among different companies may be compromised. Projecting new business could also have the effect of improving the solvency position of the company. For all these reasons, most regulatory systems that we are aware of (e.g. the Solvency II standard formula) assess the capital adequacy as of the balance sheet date for long term business. We suggest the IA consider this option for the new Framework.

For general insurance business, on the other hand, a one year projection of new business is both feasible and desirable. For non-life insurance, ASHK notes that while approaches have been developed, there are

practical difficulties in moving between results produced using core actuarial approaches when estimating uncertainties (as these are typically calibrated at ultimate - e.g. reserve risk via bootstrapping), with the proposed time horizon of one year.

Consistency between Different Classes of Business

The same target criteria should be used for all classes of business as adopting differential criteria is hard to justify. The ASHK notes that policies may contain rider benefits that may naturally fall into different classes of business relative to the bulk of the premium. The existence of differential capital criteria by class of business may promote regulatory arbitrage in the reported premium split between the rider and the core benefit, which is undesirable.

The use of consistent target criteria is in line with the ASHK's view of best practice; however, allowances for diversification should be permitted. Such allowances are only briefly referred to in the context of section 4.8 and we would welcome clearer guidance on the IA's expectations in Phase two.

Question 4

Do you agree the MCR should be designed as a simpler calculation than the PCR? Do you agree that the level for MCR should be determined after the industry QIS has been carried out? If not, why?

ASHK Response

We recognize that some regimes (e.g. Solvency II) use a simpler calculation for the MCR than the PCR. Others, such as US RBC, as well as Singapore, Malaysia, Thailand and the current Hong Kong regime, define the MCR as a percentage of the PCR. We favor this latter approach.

We agree that the MCR, as well as the PCR, should be determined with the benefit of the results of the QIS. The MCR should be calibrated to a certain confidence level as a percentage of the PCR. For example, if the QIS determines that the MCR should be calibrated to a one-in-twenty level of confidence, it might be found that this corresponds to 35% of the PCR. In this case the MCR would be defined as 35% of the PCR.

For the avoidance of doubt, the ASHK believes that once the PCR is established, it should function as the level above which the regulator does not intervene on solvency grounds. Applying a percentage greater than 100% to the PCR and setting that as the effective minimum solvency level is not consistent with the conceptual framework underlying the new regime.

Question 5

Do you agree to adopt a standardized approach as a starting point to reflect the nature and materiality of risks and calibration of PCR and MCR for all insurers while retaining the flexibility to allow internal models? If not, why?

ASHK Response

We agree to adopt a standardized approach as a starting point to reflect the nature and materiality of risks and calibration of the PCR and MCR for all insurers. To enable a smooth transition, we would suggest the standardized model should be relatively easy to implement. The calibration would be performed using broad industry statistics to ensure a balanced transition for all insurers.

Internal models should be allowed once the validation and approval guidelines and procedures are in place and provided the Insurance Authority has adequate resources to review them. To ensure a smooth transition of reported capital levels, transition rules for moving from the standardized model to the internal model need to be established.

Question 6

Do you agree with the broad categories of risk that we have initially identified as driving capital requirements, namely, underwriting risk, market risk, credit risk and operational risk? Do you agree that other risks should be better dealt with through enhanced ERM? If not, why?

ASHK Response

Any standardized approach to determining capital requirements should reflect those key/material risks that are faced by the industry as a whole, assuming they emerge over the time period being assessed and can be mitigated by holding capital. The broad risk categories described in the CP reflect those defined in paragraph 17.7.1 of the ICPs, and the ASHK agrees that these are the key/material categories of risk that should be captured by a regulatory capital assessment.

However, we note that the definitions of certain risk categories (for example, underwriting versus insurance risk and credit versus default risk) caused some debate and discussion within the group and therefore propose that the IA provides clear definitions of all risk categories and sub-categories, to ensure that all users of the framework have a precise understanding of the risks covered. This will also help companies (and the IA) to understand if they are subject to any risks that are not covered by the standardized approach, and which need to be specifically addressed in the company's Own Risk and Solvency Assessment (and possibly through capital add-ons).

Question 7

Do you agree that we should adopt a simple approach in defining capital requirements for operational risks based on premiums, new business and claims and be considered in the QIS? If not, why?

ASHK Response

For reasons of practicality we agree to adopt a simple approach in defining capital requirements for operational risks. We recommend that there be a series of simple factors applied to volume measures to determine capital requirements for operational risk.

In addition, we suggest that a number of sets of simple factors be defined representing low, medium and high operational risk, leading to lower required capital for companies with less operational risk as determined by the IA. The major reason for this structure is to reflect the actual operational risk through the required capital in order to encourage insurers to improve their operational risk management, controls and procedures. Criteria for assessing whether the low, medium or high factors would apply should be clearly defined and objective. It is important that the system should be perceived as fair by all stakeholders.

The criteria and factors should be defined in Phase 2.

Question 8

Do you agree that legal risk, liquidity risk, strategic risk and reputational risk should be addressed through risk management processes rather than by holding additional capital? If not, why?

ASHK Response

We agree that a number of risk types are not commonly considered in regulatory capital calculations; some because holding additional regulatory capital against them is not an effective way of managing the particular risk and others because the risks do not emerge over the time horizon being assessed.

Liquidity risk is an example of the first category. As described in the paper, liquidity risk is better managed through the application of broader risk management requirements. Companies should be required to identify and assess liquidity risk as part of their Pillar 2 ORSA. This assessment should reflect the company's own risk appetite, and we therefore argue that the focus of any principles should be on better asset-liability management, rather than on asset-liability matching.

In addition, regulatory requirements to assess liquidity risk on a comparable basis across the industry could be introduced, for example, through the introduction of standard stress and scenario testing requirements.

With respect to strategic risk, it is not common for this to be included in a framework with a one-year time horizon, as the risks do not emerge over this time horizon. It is therefore common for these to be assessed over the longer-term horizon used in the ORSA. Companies use such analysis to understand the risks they potentially face and how they might be managed over a longer time horizon. If there are actions which can be taken to mitigate the effect of these risks, management may then decide not to hold additional (internal) capital against these risks.

This is also true for reputational risk (which tends to be a risk to franchise value). However, we note that certain elements of reputational risk should be allowed for in the operational and insurance risk charges, for example, the risk of higher than expected lapses due to a reputational event.

It is unclear from the paper what the definition of legal risk is, and the approach used may be dependent on the definition. Certain aspects of legal risk might, for example, be included in operational risk.

Question 9

Do you agree that liquidity risk should be dealt with through enhanced supervisory oversight of ALM rather than by prescribing minimum liquidity risk standards? If not, why?

ASHK response:

Please see our answer to Question 8.

Question 10

Do you agree that a stress-test based approach should be adopted for underwriting and market risks for insurers carrying on long-term business and market risk for insurers carrying on general business? Do you agree that a risk-factor based approach should be adopted for other risks? If not, why?

ASHK Response

The ASHK broadly agrees with the appropriateness of the proposed approach for long term business in Hong Kong.

In particular we agree with the use of a stress-test based approach for market and insurance risks where liability values and potentially policyholder behavior are sensitive to asset values.

We note that it is not clear from the CP whether credit default risk on corporate bonds will be included in the market or credit risk modules. The ASHK firmly believes that this component should be included in stress tests that are applied to both the asset and liability sides of the balance sheet. However, a simpler factor based approach may be more appropriate for other default risks, for example, reinsurer default.

In relation to the above, we also consider that additional guidance will be needed to support understanding of the use of management actions to allow for the loss absorbing capacity of certain liabilities, as well as allowances for policyholder behavior.

For non-life business, the use of stress tests for market risk is likely to be of limited value given the bias towards holding material cash and short term bond positions; however, it is unlikely to be problematic to perform such stresses.

With regard to underwriting risk exposures faced by non-life insurers, the ASHK notes that most standardized approaches worldwide incorporate some finesse in their treatment of catastrophe exposures. We would like to see similar, explicit consideration given to catastrophe treatment for non-life insurers in the next phase of consultation. In particular, the following observations may be of value:

- Hong Kong is exposed to an annual windstorm season. While it is true that the financial impact of windstorms has been limited in recent years, Hong Kong is home to several reinsurers with portfolios that include some material natural catastrophe exposures.
- In principle, catastrophe losses are more appropriately captured using stress-test based approaches.
- The ASHK is cognizant that the adoption of a stress-test approach may pose challenges. Set against this, the ASHK notes that other regimes have engaged with reinsurers to support the development of both a simple factor-based approach and subsequent calibration for the cat risk load. In Thailand, for example, proposals are being considered in which a "maximum possible loss" risk driver is adopted. This approach improves on using premium-based metrics for catastrophe risk, as premium metrics do not provide benefit for better-than-average risk management practices.

Typically, we would expect to see factors applied that vary by peril (windstorm vs earthquake, say), and allowing for some geographical dimension. Over the course of time, the ASHK would urge the IA to develop a set of standard scenarios for catastrophe risk.

Question 11

Do you agree to tier capital resources based on quality? What other approaches should we consider to quantitatively assess quality and suitability of capital?

ASHK Response

The ASHK agrees with the approach suggested in the CP as well as ICP 17.11 that capital resources be grouped into various “tiers” based on quality.

Regarding the approach to quantitatively assess capital quality and suitability, we would suggest making reference to international standards from other supervisory regimes. CP 17.11 mentions “highest quality / medium / low quality capital” and in the next phase we must be able to define a set of measurable quality attributes and rules on tiering, such as permanence, subordination, and whether there are mandatory fixed charges against earnings.

In the Hong Kong environment, we suggest that the new Framework have only two tiers of capital. Tier 1 would be capital available in all circumstances, both on a going-concern basis and a wind-up basis. Tier 2 would be available only on a windup basis only. It is important that whatever capital tiers are established that it be done based on principles, rather than rules. This is because new capital instruments could well be developed in the future, which do not fit any of the “rules”. A principle-based approach avoids the need for revising the rules.

The ASHK believes that negative reserves should be recognized as Tier 1 capital. The ASHK is of the view that negative provisions are no different conceptually than positive provisions. Just as positive provisions are liabilities, negative provisions are assets. This view is consistent with the current direction of IFRS 4 Phase 2 and Solvency II. Moreover, those who are of this view note that best estimate assumptions, including voluntary terminations, underlie the entire framework and believe that they should not be singled out for additional conservatism in this respect.

Question 12

Do you agree that recognition of insurance contracts should align with general purpose financial statements under HKFRS or IFRS? If not, why?

ASHK Response

As noted in our answer to Question 1, the ASHK agrees that a total balance sheet approach should be taken to solvency regulation. We further agree that general purpose financial statements prepared in accordance with HKFRS should be the starting point for the solvency balance sheet. However, various adjustments to general purpose financial statements are appropriate. Under a total balance sheet approach it is fundamental that assets and liabilities should be valued consistently. We also believe that the new framework should allow comparisons between companies – a given solvency ratio for one company should imply the same level of risk as that same ratio for another company. Therefore we believe that the valuation principles applied to assets and liabilities should be the same for all companies.

Under HKFRS invested assets may be valued at amortized cost or fair value depending on the asset class and the company’s accounting policy choices in classifying assets. The same bond may be valued at amortized cost by one company and at fair value by another. We feel that investment assets should generally be valued at fair value for solvency reporting purposes. Fair value represents the current worth of the asset. Moreover, requiring investment assets to be valued at fair value will ensure consistency among different insurers.

There are certain assets that are recognized for general purpose financial statements that may not be appropriate to be recognized for solvency measurement purposes. These include certain intangible assets such as goodwill and deferred acquisition cost assets that generate no future cash flows. However, intangible assets that generate future cash flows or that have an actual current value should not be eliminated. These could include capitalized software and deferred tax assets subject to an appropriate demonstration of loss absorbing capacity.

As noted in the CP, there is limited guidance on valuing technical provisions (policy liabilities) under current HKFRS / IFRS. Companies are free to use whatever accounting policy they had been using at the time of adoption of HKFRS 4 and can also make improvements to that policy under certain circumstances. As a result, there is a wide range of accounting policies that insurers in Hong Kong have adopted. While each of these may meet the requirements of HKFRS 4, they are not comparable between different

companies and for this reason the ASHK does not believe that current HKFRS policy liabilities should be used as the technical provisions for solvency reporting. Rather, the principles for establishing technical provisions should be consistent between all companies.

The IASB is currently in the process of revising IFRS 4 and a new standard (IFRS 4 Phase 2) is expected sometime in 2015. The policy liabilities under the new standard, with appropriate adjustments, could serve as a basis for valuing technical provisions for solvency purposes. As currently proposed, the policy liability includes three components, namely the best estimate liability ("BEL"), including provision for the cost of options and guarantees, the risk adjustment ("RA") and the contractual service margin ("CSM").

The CSM is an artificial balancing item that eliminates any profit at issue. It is therefore a non-economic accounting device and as such should not be included in technical provisions for solvency purposes. In fact, inclusion of the CSM would guarantee that the writing of new business – no matter how profitable – would worsen the company's solvency position. This is because new business would generate no surplus initially but would generate capital requirements. This would send the wrong message to all stakeholders.

The risk adjustment is a form of Margin over Current Estimate ("MOCE"). Whether it should be included depends on whether the MOCE are included in technical provisions. See separate discussion on this topic.

We note that IFRS 4 Phase 2 has not been finalized and certain important features of the accounting model have not yet been decided by the IASB, particularly for participating business which forms a significant part of the Hong Kong long term insurance market. Our support for using it as a basis for technical provisions for solvency purposes is therefore conditional upon a satisfactory resolution of the remaining unresolved issues. We recommend that the use of the new standard be reconfirmed after it has been finalized.

Another alternative, should there be further delay in finalizing IFRS 4 Phase 2, or should the final IFRS 4 Phase 2 standard not be acceptable for whatever reason, would be for the IA to specify the rules for valuation of technical provisions, as it does under the current regime. However, the new valuation requirements would need to be very different from the current requirements. In particular:

- Technical provisions should be current estimates based on best estimate cash flows, including policy terminations by lapse and surrender;
- Discounting should be done at current market-based rates;
- The discount rate should allow for a measure of credit spread;
- The discount rate should be stabilized at durations beyond the observable tenor of a deep and liquid market for assets;
- The discount rate for contracts where the cash flows depend to a significant extent on the supporting assets should be based on those supporting assets;
- Options and guarantees should be valued.

Question 13

Do you agree to undertake valuation of assets and liabilities on an internally consistent basis and that the valuation of assets and liabilities to support the determination of capital should be derived from adjustments to the general purpose financial statements based on HKFRS or IFRS? Do you foresee any difficulties with this approach?

ASHK Response

Please see our response to the prior question.

Question 14

Do you agree to use economic valuation for all classes of business except Class G of long-term business? Are there other classes of business which should adopt an alternative approach? Why?

ASHK Response

In theory we believe that all business should be covered by an economic valuation, including Class G, to ensure a realistic and explicit valuation of both margins and risks.

However, given the existing GN7 framework which uses a 99th percentile and which from a regulatory perspective overlaps with the MPFA, we are open to the possibility of excluding Class G on pragmatic grounds provided that the overall level of security for customers is considered comparable across both regimes.

Question 15

Do you agree that market consistent approach should be used for all classes of business (option (a)) or that a combination of market consistent and amortized cost approaches should be used depending on the class of business (option (b))? Why? If you prefer option (b), which classes of business should market consistent or amortized cost approach be applied to?

ASHK Response

The CP asks whether a market-consistent approach should be used for all classes of business or, as an alternative, a combination of market-consistent and amortized cost approaches should be used depending on the class of business. Before answering this question, we would like to point out that the choice is not between these two extremes. "Market-consistent" carries with it the implication that liabilities are valued at risk-free rates. We do not believe this is appropriate. Long term liabilities should be valued at rates that are higher than risk-free rates. These liabilities are usually priced assuming that the insurer will earn a spread over risk free rates. The discount rate used for valuation should reflect at least some of this spread. This is sometimes justified as an "illiquidity premium". Alternatively, it may be justified on the grounds that history shows that insurers are, in fact able to earn a spread over risk-free rates.

In our view, the distinction should not be between market-consistent and amortized cost approaches, but rather between current estimates and amortized cost. The essential difference between the two methods is not just the choice of the discount rate. The essential difference is that the discount rate is locked in over the term of the asset or liability under the amortized cost approach, while it is updated at each valuation date based on current conditions under the current estimate approach. The current estimate approach includes the market-consistent approach as one variation, but it is much broader and also includes a variety of approaches that are "market-based" in that they reference current market conditions but do not use risk free rates to discount cash flows. We note, moreover, that the IAIS has moved away from the "market-consistent" terminology in its current work on the Basic Capital Requirement ("BCR") for Global Systemically Important Insurers ("G-SIIs") and the International Capital Standard ("ICS") for Internationally Active Insurance Groups ("IAIGs"). The technical provisions for purposes of the BCR and ICS are to be based on "current estimates". There is no mention of a "market-consistent" approach.

As noted earlier, the ASHK supports valuation of invested assets at fair value. This, then, implies that liabilities should be valued based on current estimates, including a discount rate that reflects current economic conditions. We believe this gives the most accurate picture of the current solvency position. Having said this, we have the following important caveat:

- Volatility due to changes in unobservable variables should be minimized. In particular, the discount rate used for cash flows beyond the point at which there is a deep and liquid market should be stabilized by use of an "ultimate forward rate" or other means.

Technical provisions for short term contracts may not need to be discounted. This can be justified on practicality grounds since the discounting would not have a material impact on the result and not discounting is conservative in any event.

Question 16

Do you agree with the two techniques set out in our proposal? Are there other techniques that we should consider?

Context: The two techniques are described in section 4.17.18 as follows:

- 4.17.18 We propose that the application of a market consistent approach should adopt one or both of the following techniques to avoid undue pro-cyclicality:
- (a) The discount rate is a market-referenced rate, defined with reference both to current yields and historical yields.
 - (b) The IA retains an ability to apply alternative valuation techniques during anomalous market conditions, for example, permitting or requiring the use of historical yields when markets are inactive or distressed. Such alternative valuation techniques should be defined in advance to manage industry understanding and expectations.

ASHK Response

The question needs to be considered in the context of the technical provisions (and not capital requirements in excess of the technical provisions).

We agree with the principle of eliminating pro-cyclical effects and therefore that the IA should retain an ability to apply alternative techniques during anomalous market conditions in the determination of the total capital requirements (MCR and PCR).

However, given that we believe that the technical provisions should be aligned with the methods and assumptions used for IFRS 4 Phase 2 (when this framework is finalized), we do not believe that this should apply to the basic technical provisions, but rather to the capital requirements.

Question 17

Do you agree that technical provisions should include a risk margin and allow for the time value of money? What aspects of the valuation of technical provisions should Phase II focus on? What other approaches should be considered? Why?

ASHK Response

The ASHK agrees that the technical provisions should be determined allowing for the time value of money. Having said this, we consider that discounting might not be deemed necessary for very short-tailed business.

The ASHK agrees that technical provisions should include a risk margin to provide protection against potential adverse development of insurance liabilities, consistent with ICP 14.7.

There are generally two views, namely, whether the risk margin should be included in the technical provisions in addition to the best estimate liability ("reserve margin") or earmarked in an insurer's net assets ("earmarked capital"). We acknowledge there are advantages and disadvantages of both approaches.

Reserve margins

As noted in the CP, including MOCE in technical provisions consistent with the principle that the reserves an insurer holds should be the fair value of its liabilities, i.e., the amount a third party insurer would charge to assume the liabilities. Such a third party would request a margin in addition to the best estimate liability for protection against potential downside non-hedgeable risks. We note however, that this view is consistent with an exit value approach to liability valuation rather than a going concern view where the insurer is expected to fulfil its obligations rather than transfer them to a third party.

Aside from smoothing the underwriting results over time, reserve margins serve an explicit purpose of providing a buffer against potential adverse development of claims, as opposed to earmarking a share of capital, which is meant to support all aspects of an insurer's operation. In particular, reserve margins can accommodate the risk involved in a new business, which might not be possible if earmarking capital with prescribed formula.

Reserve margins can also be calibrated to the inherent risks of the portfolio in line with the spirit of ORSA rather than a prescribed formula. A company could adopt a margin higher than the prescribed minimum to reflect the inherent risks and management's risk averseness.

Earmarked capital

Earmarking capital alone as a measure against adverse development of claims can avoid duplication, which would arise if the MOCE were to be held as part of the technical provision.

Holding MOCE as a component of technical provisions would introduce distortion to the P&L (movement of available capital) by delaying the recognition of profits if claims are settled at their best estimate values. And this is especially true for the first reporting period after implementing the requirement for MOCE, as well as in the case of companies with fast growing/shrinking portfolios.

There is usually a prescribed framework for calculating required capital, but not necessarily for MOCE. Therefore the calculation may be more transparent, if MOCE are part of earmarked surplus rather than technical provisions, where assumptions/methodologies could vary from company to company even with an agreed percentile confidence.

Paragraph 14.19.9 of the CP suggests that companies will be able to define the methodology / approach they use to calculate the MOCE. We believe that the methodology / approach used needs to be consistent across companies, as should the standard that the calibration of the MOCE reflects. This will ensure a greater degree of comparability across the industry.

Within this framework, companies should be able to set parameters which meet the defined calibration standard, but are specific to the risk profile of their underlying business, where relevant to the defined approach. We note however that smaller companies may not have sufficient data to conduct this analysis themselves, in which case development of industry parameters would be required.

As mentioned above, on balance, the ASHK supports the view that MOCE should be included as part of technical provisions.

Paragraph 14.19.9 of the CP suggests that companies will be able to define the methodology / approach they use to calculate the MOCE. We believe that the methodology / approach used needs to be consistent across companies, as should the standard that the calibration of the MOCE reflects. This will ensure a greater degree of comparability across the industry.

Within this framework, companies should be able to set parameters which meet the defined calibration standard, but are specific to the risk profile of their underlying business, where relevant to the defined approach. We note however that smaller companies may not have sufficient data to conduct this analysis themselves, in which case development of industry parameters would be required.

Whether MOCE are part of technical provisions or earmarked capital, it is important that the risks they represent not be double counted.

Question 18

Do you agree to require explicit allowance for options and guarantees? If not, what alternative approaches would be appropriate to reflect the value of options and guarantees?

ASHK Response

The ASHK agrees that the regime requires an explicit allowance for options and guarantees to differentiate the risks in products with and without such features. This is consistent with ICP 14.11.

A product portfolio offering options and guarantees should have higher technical provisions and likely higher capital requirements than one that does not. An explicit allowance for options and guarantees should enable companies to differentiate among products with different risk profiles to reflect their genuine underlying risks. This explicit allowance should also enable companies to understand the underlying options and guarantees embedded in their products early at the product development stage, and hence allow for better risk management overall.

The methodologies used to value the options and guarantees, however, could vary between companies and these variations would distort any intended comparisons on a like-to-like basis. We propose that in the next phase of the consultation, the IA set out the key principles for valuing options and guarantees, and suggest a few selected approaches for reference. This will allow companies to have a better idea of

how they can comply with the requirements so they can get prepared, while avoiding an overly prescriptive approach.

Valuation of options and guarantees is a highly technical area and one where, as mentioned earlier, the ASHK would be willing to assist the IA in developing guidance for the industry.

Question 19

Do you agree to require a cash value floor in the valuation of technical provisions? At what level should the floor be set? Are there alternative means of providing the same level of protection which you consider more appropriate?

ASHK Response

ICP 14 Valuation recognizes that assets and liabilities should be valued on an economic basis for solvency purposes. The CP recognizes that the use of a Cash Value Floor in the valuation of technical provisions is not economic. Indeed, a Cash Value Floor implicitly assumes an immediate 100% mass lapse – this is extremely unlikely and arguably detracts from the principle of going-concern. In addition, it is unclear how the cash value floor would be calculated under a 99.5th percentile stress scenario, and also potentially gives rise to the problem of double counting in the calculation of lapse stresses.

We recommend as an alternative that a mass lapse stress scenario be considered in the determination of the capital requirement, in order to provide an appropriate capital cushion.

A cash value floor on technical provisions can have severe unintended adverse consequences. Under normal circumstances, when interest rates rise, the value of fixed income assets and technical provisions will fall. Due to discounting future cash flows at higher rates. This reflects economic reality. With a cash value floor on technical provisions, once interest rates have risen to a certain level, their value will be fixed. Hence additional increases in interest rates beyond that level will lead to decrease in asset values that will be reflected dollar for dollar in available capital. In the extreme a perfectly viable company could be judged insolvent in this circumstance. The likely impact of imposing a cash value floor will be that companies remove or lower guaranteed cash values in the products they offer, thereby reducing consumer choice.

Question 20

Do you agree that asset allocation should follow principle-based requirements rather than rule-based requirements? If not, why?

ASHK Response

We believe that an insurer should be free to determine the most suitable assets to purchase and allocate them to the different classes of business that it writes, following a principle-based approach.

Pillar 1 requirements relating to capital tiering will address issues relating to the admissibility of assets, and risk based capital requirements will address issues relating to concentration risk and the individual risks associated with holding different assets.

Question 21

Do you agree with the introduction of a prudent-person principle approach for investments? If not, why?

ASHK Response

While the introduction of a prudent person rule appears to be desirable on its face, we are not sure what the implications of such a rule would be. We are generally of the opinion that companies should be allowed to invest as they see fit, in accordance with an approved ALM policy and risk appetite that have been approved by the Board of Directors. We would like to better understand what additional restrictions the IA understands would come about as a result of a prudent person rule. We suggest the IA clarify its understanding of a prudent person rule in the next phase of the development of the Framework.

Question 22

Should enhancements to the existing regulations around asset allocation and management be made by amending GN 13 (which could be achieved ahead of the proposed implementation of the RBC framework)?

ASHK Response

We agree that a guidance note is a suitable place to include requirements regarding security, diversification and liquidity of investments since these are areas where risk management techniques are more likely to evolve as asset classes and the economic environment evolves, and this provides greater flexibility for keeping such requirements up to date and relevant to the industry.

We agree that GN13 would need to be enhanced for this purpose.

Question 23

Do you agree that all insurers should be required to do their ORSA having regard to their own business strategy and environment in addition to the PCR set by the IA? If not, why?

ASHK Response

The ASHK agrees that insurers should be required to do their ORSA having regard to their own business strategy and environment in addition to the PCR set by the IA, as the ORSA captures insurer-specific risks, including, for example, strategic risk and liquidity risk that are not captured in the PCR. As well as being aligned with the requirements set out in ICP 16.14, this will help to ensure that the ORSA can become part of an effective risk management system, rather than just a "tick-box" regulatory requirement. We do however consider that all ORSA requirements should be proportional to the size and complexity of the insurer.

Question 24

Do you agree to enhance ERM and corporate governance standards by introducing an ORSA requirement, including stress and scenario testing and continuity analysis? Should these standards be introduced ahead of new Pillar 1 requirements?

ASHK Response

The ASHK agrees that the introduction of ORSA requirements can help insurers to improve their broader risk governance and risk management practices. We note however, that risk management processes and practices can take a significant amount of time and resources to implement and to integrate into broader business and strategic decision making processes, and that companies in Hong Kong are currently at very different levels in terms of their risk management development and sophistication. We therefore propose that the IA consider conducting a study (similar to a QIS exercise) to assess the capabilities of insurers to comply with ORSA requirements before they are formally implemented.

The level of detail provided in the CP in relation to the ORSA is limited, and conducting a study of this type will give the IA the opportunity to provide more guidance on what is required from companies. This should be specific enough that companies with limited current capabilities in this area will be able to develop something meaningful, but generic enough that those that currently have well defined and developed processes and practices do not have to adjust these to meet regulatory requirements – the ORSA should after all be company specific.

Question 25

Do you agree to apply the principles of proportionality to the Pillar 2 requirements of the RBC regime? If not, why?

ASHK Response

Yes, the ASHK agrees that the principle of proportionality should be applied to the Pillar 2 requirements. Proportionality is fundamental to proper risk management. Without a proportionality principle, *all* risks would be treated with equal importance and resources would necessarily be diverted from significant risks to insignificant (or at best less significant) risks. This is not only inefficient, but also has the potential to cause certain aspects of significant risks to be overlooked in the analysis.

Question 26

Do you consider that the IA should have the power to apply capital add-ons in the event of inadequate corporate governance and/or ERM commensurate with the scale and complexity of the insurer?

ASHK Response

We consider that the IA should have the power to apply capital add-ons in the event of inadequate corporate governance and/or ERM commensurate with the scale and complexity of the insurer. Having said that, we would like the IA to provide more clarity on the following matters:

- i. How will the add-on requirements be defined and how will objectivity be ensured?
- ii. Will there be any transition period allowed to address inadequacies so that the add-on may be avoided?
- iii. What required actions are necessary to address the inadequacy?
- iv. How will the inadequacy be monitored and measured?
- v. Will add-ons be disclosed or be confidential between the IA and the insurer?

We believe that a transparent process for to determine add-ons is key to the perception of fairness and consistency of treatment across companies.

Question 27

Do you agree that insurers should, in addition to the statutory reporting to the IA, disclose to the public information about their risk assessments, capital resources and capital requirements in their published accounts and that enhanced disclosure requirements are addressed once proposals in respect of Pillar 1 and Pillar 2 are further evolved? If not, why?

ASHK Response

The ASHK suggests that care be taken in moving from the current regime of relatively little public disclosure to one where information such as risk assessment, capital resources and capital requirements are published. This is particularly the case where the valuation basis is moving to an economic one and solvency measures are likely to become more volatile. Adequate education is necessary for those who have access to this kind of disclosure, as there could be a high risk of misinterpretation leading to loss of confidence in individual companies or the industry as a whole.

The ASHK therefore recommends that information relating to capital resources and requirements be disclosed privately to the IA first. However, the more qualitative information relating to risk assessment, governance and ERM practices could be disclosed publically with less chance of misinterpretation, and indeed help to gain confidence and serve in educating the public in their understanding of the insurance industry.

We also note that securities laws regarding price-sensitive information need to be respected. Any disclosure requirements under the new Framework should not conflict with securities laws.

Question 28

Do you agree to introduce requirements to set up on-shore and off-shore funds? If not, why?

ASHK response

Under the ASHK's Professional Conduct Code, there is a requirement for actuaries to act in the public interest. With this context in mind, the ASHK agrees with the CP's assertion that the same level of protection should be afforded to policyholders whether they are insured by locally-incorporated insurers or if they obtain cover through branch operations of overseas insurers established in Hong Kong. This requirement for equity can be addressed through the proposed introduction of requirements to establish on-shore and off-shore funds, which the ASHK therefore supports.

Question 29

Do you agree that group-wide supervision should be applied to each of the Pillars? If not, why?

ASHK Response

We agree that group-wide supervision should be applied to those aspects of each of the pillars that affect group-wide risk. In particular, we agree that it should be applied to the following issues listed in Paragraph 7.2.7:

- Hong Kong policyholders are adequately protected and not placed at any disadvantage due to risks taken by any entities in the group
- Coordination and cooperation with other relevant supervisors
- Risks arising from the group's perspective

Question 30

Do you agree with the definitions of insurance groups and subgroups? Do you consider that they can be applied with sufficient clarity?

ASHK Response

While we believe the meanings of "insurance group" and "insurance subgroup" are intuitively clear, we find the definitions given in Paragraphs 7.3.6 and 7.3.7 of the CP to be confusing. For example, in the definition of insurance group it would seem that each of the entities listed in 7.2.6 is an insurance group since the word in the next to last bullet of 7.2.6 is "or" rather than "and". In 7.3.7 one of the three possibilities listed for a subgroup is an authorized insurer that "belongs to a subgroup..." In other words "subgroup" is defined in terms of "subgroup". We suggest that this section be re-written to make it clear exactly what the intention is with regard to the meanings of insurance group and subgroup.

Question 31

Do you agree that whether supervision of subgroups should be based on size, specifically whether premiums or assets exceed a benchmark? If not, why?

ASHK Response

It is not clear which aspect(s) of group-wide supervision the question refers to. The CP lists three types of group-wide supervisory approaches, namely (i) capital requirements prescribed at the group level, (ii) corporate governance and ERM and (iii) reporting requirements of group events and intra-group transactions. Clearly, if a group is headquartered in Hong Kong, the requirements should apply regardless of size. Similarly for HK authorized insurers that are members of a group, we believe the reporting of group events and intra-group transactions should apply regardless of the size of the Hong Kong insurer since such events and/or transactions could have an impact on the Hong Kong insurer. However, we think it is reasonable to exempt a Hong Kong authorized insurer from the group-wide ERM supervision if it is below a certain threshold size. It is sufficient that the IA be comfortable with ERM at the solo company level.

Question 32

Do you agree that PCR and MCR at a group level should be established as the triggering points for different degree of supervisory intervention? If not, why?

ASHK Response

In general, we believe that actions should be targeted to ensure assets backing Hong Kong policyholder liabilities are held in Hong Kong (if there are no offshore funds set up by the group for Hong Kong liabilities and capital requirement).

For a tier 1 group, we agree that PCR and MCR should be the triggering points for supervisory intervention for the Hong Kong regulated entity. For other types, the Hong Kong based entity should be supervised according to the PCR and MCR for that entity.

Question 33

Do you agree that the group-wide capital requirement should be based on a group level focus approach (i.e. considered as a single integrated entity, rather than a set of interdependent legal entities) and use the consolidation method rather than the aggregation method? If not, why?

ASHK Response

This is currently the subject of a great deal of discussion and debate internationally. As a broad generalization, the European approach is to use the consolidation approach whereas the US approach has been to use the legal entity approach.

Some members agree that a group-wide capital requirement should be based on a group level focused approach and use the consolidation method, other than restrictions to ensure that assets backing Hong Kong policyholder liabilities are held in Hong Kong (if there is no offshore fund set up by group for Hong Kong liabilities and capital requirement).

This means that there would be a need to demonstrate that there is sufficient available capital held within the group in total to cover the Hong Kong group-wide requirement, allowing for diversification between geographies.

To be clear, where the contribution to this group-wide level of capital is greater than the local requirement in respect of a particular overseas unit, there should be no need to hold this capital in that country provided it is deemed available to be injected into that unit if required (i.e. provided it is fungible). The remaining capital should be viewed as fungible across the group (subject to local geographical capital restrictions) – under a stress event over a one-year period, it is likely that the Group will be deploying available capital across its businesses where possible.

Other members believe that the legal entity approach is preferable to the consolidated approach. Under the legal entity approach, Hong Kong would accept the local solvency basis in jurisdictions that are deemed to be equivalent to Hong Kong. For other (non-equivalent) jurisdictions the local basis would also be used, but additional capital could be required to be held at the (sub)group level. The total requirement for the (sub)group would be the sum of the requirements of each of the legal entities within the (sub) group. This approach creates a level playing field for group members in jurisdictions outside Hong Kong that are deemed equivalent. In those jurisdictions, the same capital requirement would apply to local players as well as members of the Hong Kong based (sub) group. Additionally, it does not take credit for geographic diversification, consistent with the premise that in times of severe crisis, capital is actually *not* fungible because regulators will ring-fence assets held locally to protect the policyholders in their jurisdictions. In fact this implies any extra capital under the consolidated approach imposes a burden during good times which is not available for its intended purpose during a severe crisis.

To avoid making Hong Kong an unattractive domicile for multinational companies, we urge the IA to consider this issue carefully given the lack of global convergence in insurance capital requirements.

Question 34

Do you think that the IA should require the group to carry out its ORSA at a group level and apply consistent policies for assessing their individual insurance entities?

ASHK Response

Yes, we agree in principle. However, the IA should adhere to the principles of the ORSA. The ORSA should present the insurer's view of its risks. It should not be overly prescriptive. It is noted that other supervisor may impose conditions on the ORSA of Hong Kong insurers. Likewise, the OCI requirements would apply to subsidiaries of Hong Kong-based (sub)groups based in other jurisdictions. The ASHK urges the OCI to work with other regulators to establish a system of equivalence so that insurers would not need to prepare two ORSA to satisfy the requirements of two different regulators.

Question 35

Do you agree that all authorized insurers should be required to submit to the IA (i) prior notification of material intra-group transactions as well as material events or transactions of the group, and (ii) regular reporting of risk exposures within the group?

ASHK Response

The ASHK has some reservations on requiring prior notification with impact assessment of all material transactions of the group as well as regular reporting of risk exposure within the group including non-regulated entities. While material intra-group transactions with the insurance entity are of high relevance

to the overall financial security, transactions between non-regulated entities alone seem to be less relevant. The ASHK suggests that the requirement should be different between intra-group transactions with the insurance entity and transactions of non-regulated entities, similar to the difference in the minimum list of transactions or events requiring disclosure.

Question 36

Do you agree with the minimum list of transactions or events requiring disclosure? If not, why?

ASHK Response (Penny Fosker)

The ASHK agrees with the minimum list of transactions or events requiring disclosure as a starting point. The listed transactions and events include most of the common items that can materially affect the solvency position of an insurance entity. Derivatives positions for intra-group transactions may need to be explicitly considered.

Question 37

Do you agree with the proposed approach to group-wide supervision? Are the three tiers sufficiently clearly defined and do they in practice merit different approaches?

ASHK Response

The ASHK agrees in principle to categorize the supervision of companies in accordance with their reporting structure within their holding group and the nature and supervision applied on the respective holding group they belong to. However, we would ask for more clarity around the definition of the "tiers". The Figures contained in the CP do not provide a sufficiently clear view of how each company fits into the proposed supervisory scheme.

Under Tier 1 supervision, the Insurance group is one incorporated in Hong Kong. The requirements seem clear in this case. Under Tier 2 however, where a Hong Kong operation belongs to a group incorporated outside of Hong Kong and is subject to other home country regulations, the CP appears to call for an ORSA report on the whole group to be done according to the Hong Kong requirements. Does this mean an ORSA report is to be submitted including all other members of the group even though they are outside Hong Kong? We would like more clarity on this point.

Contract Boundaries

The CP defines contract boundaries in the same way as the IASB's exposure draft for IFRS 4 Phase 2, with the stated rationale of avoiding creating subtle differences in regulatory and accounting requirements, and therefore maintaining multiple sets of records and having multiple rounds of system changes. The context here is the use of the 'contract boundary' definition to ascertain the cash flows to be used in the determination of Current Estimates (CE). To re-cap, cash flows are within a contract boundary when:

- (i) The insurer can compel the policyholder to pay the premiums within that boundary; OR
- (ii) The insurer has the ability to re-price at the individual contract level; OR
- (iii) Both the following conditions apply:
 - (a) The insurer has the ability to set a price or benefit level that fully reflects the level of risk at the contract portfolio level AND
 - (b) The pricing up to the risk re-assessment date does not take into account risk relating to future periods

The majority of Task Force members agrees with the above approach as proposed in the CP on the definition of 'contract boundary' for the purpose of defining the cash flows that are used in the determination of the CE.

However, a minority of members is of the view that the definition should not be based on the legal terms of the contract, as proposed in the IASB's exposure draft, but rather on economic substance, reflecting the cash flows actually expected under the contract. It is hoped that the IASB would change its approach to be consistent with this economic view in the final standard.

Diversification

The current CP only makes passing reference to allowances for Diversification under section 4.8.

The ASHK recognizes that the primary purpose of the CP is to outline the principles of the proposed regime. Diversification of risk is typically a key consideration when developing a view of the risks faced by an enterprise. To this end we would urge clear and explicit guidance in the next phase of Consultation.

Within section 4.8 there is a reference to diversification potentially reducing or increasing capital requirements. It is our view that aggregating different sources of risk will almost always reduce risk through the principle of diversification. The CP makes reference to the idea that stressed conditions may increase the total capital requirement. This is misleading. The ASHK accepts that stressed conditions may cause an increase in the correlation between different sources of risk; however, a diversification benefit still exists albeit that the extent of the benefit is less than would be experienced in more benign conditions. This should be catered for in establishing the approach to diversification in the first instance, for example by setting the correlation coefficients based on stressed rather than normal circumstances.

In drafting the next phase of consultation, we would anticipate that diversification would be reflected in a number of areas, e.g. "between risk categories" (e.g. underwriting risk vs credit risk, etc.) as well as between and "within risk categories" (e.g. new business vs in-force exposures, attritional vs catastrophe exposures for non-life, etc.).

ERM Generally

Insurance companies in Hong Kong will be at very different stages of readiness to comply with a Pillar 2 supervisory framework. The submission of a draft ORSA before the regulations are finalized should be considered - alongside a series of QIS exercises - to enable the regulator to assess the state of readiness of the industry as a whole for a Pillar 2 environment.

There are no questions in the consultation document around the scope of Pillar 2 and its associated ERM requirements. Much greater specificity is needed in this regard.

The level and depth of analysis expected from an ORSA - and to what extent the industry is in a position to deliver this analysis in terms of models, data and expertise - is an area that needs to be fleshed out before regulations are finalized.

In terms of timetable we believe that it is likely to take a significant period of time to finalize the requirements of Pillar 1 and to assess through the QIS process the impact that this will have on the insurance industry. There are elements of both Pillars 2 and 3 that we think could be brought in more quickly to improve ERM techniques practiced in the industry and this should be explored in parallel with and if appropriate in advance of the completion of Pillar 1.

Treatment of Reinsurers, Requirements for Offshore Reinsurance Funds and Captives

We understand from the HKFI OCI briefing on 30 October that the above will be thought through and decided at a later stage (the CP is silent on these points). While the intention is to adopt the broad principles of the ICPs, some flexibility remains in these areas. The decisions in these areas will have implications for Hong Kong as an international financial center, while at the same time the entities affected will need time to make preparations for any changes. We propose that these issues be addressed (even if in stages and even if it is just on the thinking around these issues, initially) in the next round of communication.

4. Appendix: ICP 8.5

- 8.5.1 A robust actuarial function that is well positioned, resourced and properly authorised and staffed is essential for the proper operation of the insurer.
- 8.5.2 The actuarial function should have access to and periodically report to the Board on matters such as:
- any circumstance that may have a material effect on the insurer from an actuarial perspective;
 - the adequacy of the technical provisions and other liabilities;
 - the prospective solvency position of the insurer; and
 - any other matters as determined by the Board.
- 8.5.3 Written reports on actuarial evaluations should be made to the Board, Senior Management, or other Key Persons in Control Functions or the supervisor as necessary or appropriate or as required by legislation.
- 8.5.4 The actuarial function should carry out such activities as are needed to evaluate and provide advice to the insurer in respect of technical provisions, premium and pricing activities and compliance with related statutory and regulatory requirements. The actuarial function evaluates and provides advice on matters such as:
- the insurer's actuarial and financial risks;
 - the insurer's investment policies and the valuation of assets;
 - an insurer's solvency position, including a calculation of minimum capital required for regulatory purposes and liability and loss provisions;
 - an insurer's prospective solvency position;
 - risk assessment and management policies and controls relevant to actuarial matters or the financial condition of the insurer;
 - distribution of policy dividends or other benefits;
 - underwriting policies;
 - reinsurance arrangements;
 - product development and design, including the terms and conditions of insurance contracts;
 - the sufficiency and quality of data used technical provisions; and
 - risk modelling in the ORSA and use of internal models.
- 8.5.5 Where required, the actuarial function may also provide to the supervisor certifications on the adequacy, reasonableness and/or fairness of premiums (or the methodology to determine the same) and certifications or statements of actuarial opinion.
- 8.5.6 The supervisor should clearly define when such certifications or statements of actuarial opinion need to be filed. When these are required to be filed, the supervisor should also clearly define both the qualifications of those permitted to certify or sign such statements and the minimum contents of such an opinion or certification.

Appointed actuary

- 8.5.7 Some jurisdictions may require an "appointed actuary," "statutory actuary," or "responsible actuary" (hereinafter referred to as an "Appointed Actuary") to perform certain functions, such as determining or providing advice on an insurer's compliance with regulatory requirements for certifications or statements of actuarial opinion. The tasks and responsibilities of the Appointed Actuary should be clearly defined and should not limit or restrict the tasks and responsibilities of other individuals performing actuarial functions.
- 8.5.8 The insurer should be required, at a minimum, to report the Appointed Actuary's appointment to the supervisor.

- 8.5.9 The Appointed Actuary should not hold positions within or outside of the insurer that may create conflicts of interest or compromise his or her independence. If the Appointed Actuary is not an employee of the insurer, the Board should determine whether the external actuary has any potential conflicts of interest, such as if his or her firm also provides auditing services to the insurer. If any such conflicts exist, the Board should subject them to appropriate controls or order other arrangements.
- 8.5.10 If an Appointed Actuary resigns or is replaced, the insurer should notify the supervisor and give the reasons for the resignation or replacement. In some jurisdictions, such a notification includes a statement from the insurer of whether there were any disagreements with the former Appointed Actuary over the content of the actuary's opinion on matters of risk management, required disclosures, scopes, procedures, or data quality, and whether or not such disagreements were resolved to the former Appointed Actuary's satisfaction.
- 8.5.11 The supervisor should have the authority to require an insurer to replace an Appointed Actuary when such person fails to adequately perform required functions or duties, is subject to conflicts of interest or no longer meets the jurisdiction's eligibility requirements.